

Introductory Section



Plymouth Rock is located inside of a vault in a waterfront park beside the Mayflower II. Legend is that it served as the welcome mat for the Pilgrims in 1620.

Massachusetts is the sixth smallest state, but large in the concentration of national historic and cultural landmarks. The name Massachusetts was taken from an Indian tribe that lived near Milton, Massachusetts, meaning “large hill place.”

Henry Cabot Lodge said, “New England has a harsh climate, a barren soil, a rough and stormy coast, and yet we love it, even with a love passing that of dwellers in more favored climates.” Most of those who live in Massachusetts would agree with him.

The state is comprised of almost a dozen regions, each with its own distinct features, culture, and sightseeing attractions to explore. It is our intent in this volume to give the reader a brief introduction to a sampling of interesting destinations, some well known and some off the beaten path.



William Kilmartin, Comptroller
One Ashburton Place
Boston, MA 02108

December 22, 1998

*To the Citizens of the Commonwealth of Massachusetts,
Governor Argeo Paul Cellucci, and Honorable Members of the General
Court*

It is with great pleasure that I transmit the Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 1998 (FY98). This is the thirteenth time we have reported the Commonwealth's financial results in accordance with generally accepted accounting principles (GAAP). As I conclude my service as State Comptroller by virtue of a term limit, I am pleased to report that the financial condition of the Commonwealth is excellent.

For the eighth consecutive year revenues have exceeded expenditures by a significant amount. It was not long ago, in FY90, that the Commonwealth reported in the Budgeted Funds a GAAP deficit fund balance of \$1.9 billion. We now report a positive GAAP fund balance in these funds of \$1.8 billion. Years of prudent fiscal management, characterized by structurally balanced budgets, combined with a favorable economy, have caused this turnaround. The Commonwealth's strategic reserve, called the Stabilization Fund, is now funded in the amount of \$1,159.6 million. In addition, \$367.6 million has been reserved for tax reduction. In FY90 and FY91, the Commonwealth resorted to over \$1.8 billion in deficit borrowing. That deficit borrowing was completely repaid in FY98. The ongoing challenge to Commonwealth policy makers is to sustain this excellent financial condition.

The Office of the Comptroller is responsible for the fair presentation of the financial statements of the Commonwealth and for the preparation of this Comprehensive Annual Financial Report which is presented in three sections: Introductory, Financial, and Statistical. The three sections of the CAFR, as detailed in the table of contents, include the information necessary for the reader to obtain a comprehensive understanding of the Commonwealth's financial position and the results of its operations for FY98.

The CAFR is prepared in accordance with GAAP as established by the Governmental Accounting Standards Board (GASB), the professional standards of the American Institute of Certified Public Accountants (AICPA), the recommendations of the Government Finance Officers Association (GFOA), and the requirements of state finance law.

The Office of the Comptroller transmits the Comprehensive Annual Financial Report for FY98 in accordance with Section 12 of Chapter 7A of the General Laws.

In FY98 the Commonwealth implemented two new GASB statements:

Statement No. 31 "Accounting and Financial Reporting for Certain Investments and for External Investment Pools". This implementation had no material effect on the Commonwealth's financial statements.

Statement No. 32 "Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans". GASB 32 was issued in response to changes by the IRS regarding so called 457 plans. As a result of the tax law changes, and the Treasurer's execution of Plan Trust Agreement, as required by these changes, the Commonwealth's Deferred Compensation Plan is now presented as a Trust Fund.

BUDGETED FUNDS OPERATIONS

The portion of state finances that typically engenders the highest degree of interest is the Budgeted Funds. These include the General, Local Aid, Highway, and certain Special Revenue Funds which comprise the annual state budget.

Budgeted Funds Operations - GAAP Basis

(Amounts in millions)

	FY94	FY95	FY96	FY97	FY98
Beginning fund balances (deficits).....	\$ (184.1)	\$ (72.0)	\$ 287.4	\$ 709.2	\$ 1,096.3
Equity transfer	-	91.0	-	-	-
Restated beginning balances (deficits)	(184.1)	19.0	287.4	709.2	1,096.3
Revenues and other financing sources.	15,804.9	16,517.5	17,524.6	18,845.9	20,339.9
Expenditures and other financing uses.	15,692.8	16,249.1	17,102.8	18,458.8	19,594.8
Excess.....	112.1	268.4	421.8	387.1	745.1
Ending fund balances (deficits).....	\$ (72.0)	\$ 287.4	\$ 709.2	\$ 1,096.3	\$ 1,841.4

Budgeted Funds Operations - Statutory Basis

(Amounts in millions)

	FY94	FY95	FY96	FY97	FY98
Beginning fund balances	\$ 562.5	\$ 589.3	\$ 726.5	\$ 1,173.0	\$ 1,394.0
Revenues and other financing sources.	15,979.2	16,930.8	18,371.4	19,223.3	21,404.6
Expenditures and other financing uses.	15,952.4	16,794.1	17,924.9	19,002.3	20,606.5
Excess	26.8	136.7	446.5	221.0	798.1
Ending fund balances.....	\$ 589.3	\$ 726.5	\$ 1,173.0	\$ 1,394.0	\$ 2,192.1

The table of Budgeted Funds Operations - GAAP Basis sets forth a multi-fiscal year view of financial performance for the Budgeted Funds under GAAP, and also provide a comparison to the same funds as accounted and reported under the statutory basis of accounting.

On the statutory basis of accounting, which is used to develop the Commonwealth's budget and control its daily activities, the Budgeted Funds have achieved positive ending fund balances for each of the years, during the five year period ended June 30, 1998 increasing this fund balance from \$589.3 million in fiscal year 1994 to \$2,192.1 million in the current fiscal year for a cumulative improvement of \$1,602.8 million.

Over the same period on a GAAP basis, operating gains have improved fund balance from a deficit \$72.0 million to a positive \$1,841.4 million, with cumulative improvement of \$1,913.4 million. Simply stated, the widely acknowledged efforts to accomplish fiscal balance on a statutory basis are even more impressive when viewed on a GAAP basis.

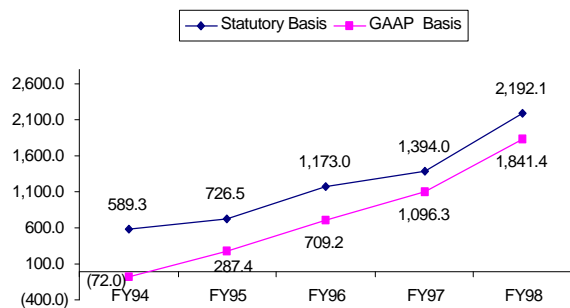
The basic principle of GAAP is to match inflows pertaining to the fiscal year to outflows for the same period in order to demonstrate if the objective of interperiod equity has been accomplished. A modified accrual basis of accounting is employed to recognize certain assets and liabilities. Accomplishment of interperiod equity is denoted by an increase in fund balance, and the failure to accomplish that goal is denoted by a decrease in fund balance. The effect of fund deficits shifts the burden of funding expenditures incurred in prior years to taxpayers in future years. The Commonwealth has provided not only revenues to match expenditures in the current year, but also excess revenues to "catch up" on prior year deficits and more recently fund reserves for future fiscal years.

In FY98, the revenues and other financing sources totaled \$20,339.9 million. The Budgeted Funds - GAAP Basis chart shows the percentage of revenue by type contributing to that total. Budgeted Funds expenditures and other financing uses totaled \$19,594.8 million in FY98. The chart depicts the percentage of each major program in this total.

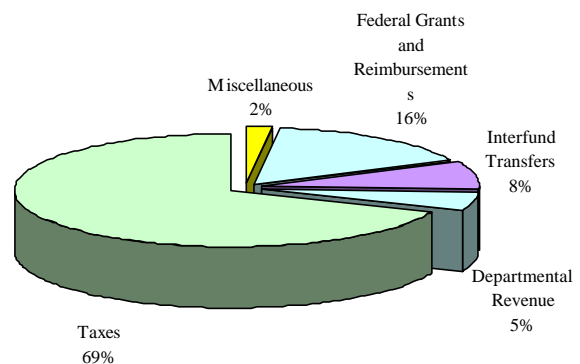
There are five major items that account for almost all the difference between the statutory basis reporting and GAAP: Medicaid, subsidies to authorities, compensated absences, claims and judgments, and tax revenues.

For the Medicaid program, expenditures under the statutory basis of accounting are equivalent to cash disbursements. Thus bills for services rendered in the fiscal year but not paid, or rate adjustments owed but not paid, are not measured in that year, but "pushed" into the next fiscal year. Under GAAP, such items are accrued, so that all expenditures are consistently correlated to the fiscal year to which they pertain. The Medicaid expenditures measured on a GAAP basis for FY98 were \$3,637.8 million, which is 4% higher than FY97. This increase is equivalent to the increase for total budgeted expenditures from FY97 to FY98. For several years the Commonwealth aggressively pursued a policy to constrain expenditure growth in Medicaid, thus helping to balance the overall budget. In FY98, the Commonwealth authorized expanded programs and services with increased spending. It is important to assure Medicaid service expansion conforms to affordable growth in the overall budget.

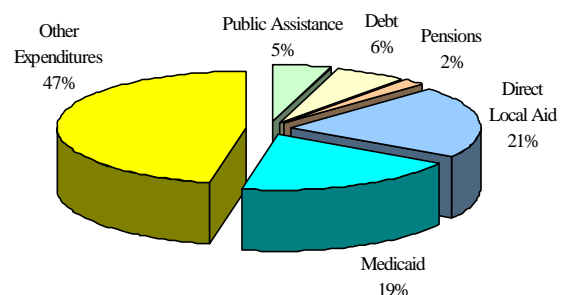
**GAAP VS. STATUTORY
Trends in Fund Balance
(Amounts in millions)**



**BUDGETED FUNDS - GAAP BASIS
Revenue and Other Financing Sources**



**BUDGETED FUNDS - GAAP BASIS
Expenditures and Other Financing Uses**



The second difference is the Commonwealth subsidies to the Massachusetts Bay Transportation Authority (MBTA), the Regional Transit Authorities (RTAs), and the Massachusetts Convention Center Authority (MCCA). Through various laws the Commonwealth has obligated itself to provide subsidies to these component units for operations and debt service. However, the annual budget is appropriated on a basis which "lags" behind the total amount of the subsidy. Under GAAP, this amount is accrued, so that the total obligation is measured. For many years the amount for the "not yet appropriated" subsidy was growing at rates higher than the total budget.

However, in recent years this trend has varied, and in FY98 the amount accrued for MBTA subsidy obligations increased from FY97 by \$12.2 million. On May 4, 1998, the House Committee on Ways and Means approved "forward funding" legislation that would substantially modify the funding mechanisms for the MBTA. Under the legislation, which would take effect in fiscal 2000, the Commonwealth's annual obligation to support the MBTA for operating costs and debt service would be limited to the revenues raised by 1% sales tax, to be funded from existing sales tax receipts. The 1% sales tax amount would be dedicated to the MBTA under a trust fund mechanism that is intended to not permit future legislatures to divert the funds or reduce the sales tax rate below 1%. The dedicated revenue stream would be disbursed to the MBTA, to be used to meet the Commonwealth's current debt service contract assistance obligations relating to MBTA debt and to meet the MBTA's other operating and debt service needs. The Commonwealth would not be liable to pay the MBTA's net cost of service, nor would the Commonwealth be liable for debt service contract assistance on MBTA bonds issued after June 30, 1999. To replace the working capital of the MBTA currently supplied by operating notes and cash advances from the State Treasurer, the legislation would authorize the Commonwealth to issue up to \$675 million in general obligation bonds. This legislative proposal is not yet enacted.

The third difference is compensated absences. Under the Statutory basis of accounting, the vacation and sick time taken by employees is expensed as it is used. Under GAAP, the amounts owed for vacation earned but not yet taken and certain amounts of sick leave are accrued and reported as expenditures of the fiscal year. The trend for compensated absences has been relatively consistent.

The fourth difference is claims and judgments. Under the statutory basis, amounts owed in lawsuits for torts, tax disputes, eminent domain land takings, or other legal actions are not measured as expenditures until the lawsuit is decided and the settlement is actually paid. Under the GAAP basis, an analysis is performed on all litigation, and an amount is accrued for that portion of litigation where a settlement against the Commonwealth is considered probable.

The fifth difference between statutory and GAAP relates to tax revenue. For several reasons, as an example the extension of an income tax return, a taxpayer's obligation incurred in a fiscal year might not be fully collected until the ensuing fiscal year. Under GAAP, an analysis is conducted in conjunction with the Department of

Revenue (DOR), and an accrual for revenue is computed. In FY98 the value of accrued revenue was \$505.1 million in FY98.

GOVERNMENTAL FUND OPERATIONS

The Governmental Fund Types include all funds where the Commonwealth imposes its sovereign authority to create revenues and authorize expenditures. This includes all Budgeted Funds as previously described (General and several Special Revenue Funds), all other (non-budgeted) Special Revenue Funds, and the Capital Project Funds. When viewed as a whole, these funds portray the Commonwealth's comprehensive governmental financial activity. The five year trend of operations, on a GAAP basis, is summarized in the following table.

Within the Capital Projects Funds component of the Governmental total, the Commonwealth issued approximately \$517.7 million in project financing in early FY99 instead of late FY98. Had such capital project financing been issued in FY98, the Governmental Funds positive fund balance would have increased by an equivalent amount.

Governmental Fund Operations (Amounts in millions)

	FY94	FY95	FY96	FY97	FY98
Beginning fund balances (deficits).....	\$ (478.3)	\$ (273.7)	\$ (16.3)	\$ 644.6	\$ 1,030.6
Equity transfer	-	15.5	-	-	-
Restated beginning balances (deficits).....	(478.3)	(258.2)	(16.3)	644.6	1,030.6
Revenues and other financing sources.....	23,226.0	24,216.4	25,102.3	27,372.9	31,249.3
Expenditures and other financing uses.....	23,021.4	23,974.5	24,441.4	26,986.9	30,416.8
Excess	204.6	241.9	660.9	386.0	832.5
Ending fund balances (deficits).....	\$ (273.7)	\$ (16.3)	\$ 644.6	\$ 1,030.6	\$ 1,863.1

INTERNAL SERVICE FUNDS

In FY95 the Commonwealth established for GAAP reporting purposes three Internal Service Funds. These funds account for the operations of the State Employees Workers' Compensation Program, a special workers compensation program for the Central Artery/Third Harbor Tunnel Project, and for the health insurance programs administered by the Group Insurance Commission. On the statutory basis of accounting these funds have not been created and are not reported. The adjusting entries to report these "GAAP only" Funds represent another difference from the statutory basis.

The Commonwealth self-insures for the State Employees Workers' Compensation Program. This program was administered by the Public Employee Retirement Administration Commission (PERAC) through FY97. Effective July 1, 1997 administration of state employees' workers' compensation has been transferred to the Human Resource Division. Inflows to the program are amounts charged to state departments;

outflows are expenses for claims and settlements, and accrued expenses for claims which will be paid in the future. The traditional policy has been to set chargebacks equivalent to claims paid, typically referred to as a “pay as you go” approach. As a result, an unfunded liability of \$248.8 million has accumulated, of which \$35.5 is considered short term (payments expected within one year). The Commonwealth should consider a plan to increase annual chargebacks, thus eventually funding such liability.

In regard to the Central Artery/Tunnel Project, the Executive Office of Transportation and Construction, with the approval of the U.S. Department of Transportation, has created a special workers' compensation program to cover all participants (including employees of contractors) on the project. In this arrangement, annual premiums and investment earnings are accumulated by the insurance carrier to fund current and future claims. The approach is expected to diminish this potentially expensive component of the large, multi-year construction project. With four years experience, it is evident that amounts contributed to the program significantly exceed the actuarial determined cost of current and future claims benefits. With this situation (the opposite of the State Employees Workers' Compensation Program), the Executive Office of Transportation and Construction should consider a plan to decrease annual premiums, and thus lower the accumulated balance, on a go-forward basis. The respective contributions of both state and federal governments must be considered in any change to this program.

The Group Insurance Commission manages the health insurance program for state employees, retirees, and their beneficiaries. Revenues to the program are amounts contributed by individuals, participant organizations, or by the Commonwealth; and the expenses are claims, plus accruals for claims incurred but not reported. The accumulated balance, while a small deficit, is not material to the size of the program, suggesting that symmetry of inflows to outflows is reasonable and change is not warranted.

Internal Service Fund Operations

(Amounts in millions)

	FY95	FY96	FY97	FY98
Beginning retained earnings (deficits).....	\$ -	\$ (223.4)	\$ (151.0)	\$ (140.3)
Operating gain.....	127.9	68.7	3.2	74.4
Other revenues	6.0	3.7	7.5	10.8
Equity transfer.....	(15.7)	-	-	-
Balance from the General Long-Term Obligations.....	(341.6)	-	-	-
Ending retained earnings (deficits).....	<u>\$ (223.4)</u>	<u>\$ (151.0)</u>	<u>\$ (140.3)</u>	<u>\$ (55.1)</u>

FIDUCIARY FUND OPERATIONS

The Fiduciary Fund Type consists of funds where the Commonwealth is acting as an agent or steward for funds which relate to another party. The Fiduciary Fund Type includes the Expendable Trust, Nonexpendable Trust, Pension Trust, and Agency Funds.

The Nonexpendable Trusts account for assets held with restrictions and the Agency funds account for assets managed temporarily on behalf of other parties. The amount of such assets managed by the Commonwealth decreased by \$942.7 million during FY98 to \$6,028.0 billion due primarily to the implementation of GASB 32, moving deferred compensation from the Agency funds to the Deferred Compensation trust fund of \$2,006.4 million.

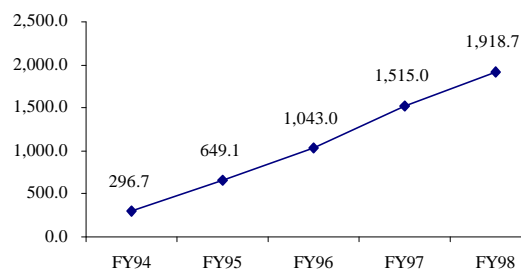
The Expendable Trusts ended FY98 with a fund balance of \$4.1 billion composed of a balance of \$213.1 million in Expendable Trusts and \$1,918.7 million in the Unemployment Compensation Trust Fund and \$2,006.4 million in the Deferred Compensation Trust Fund.

The Commonwealth is responsible for the payment of pension benefits to its employees and to the teachers of the cities, towns, and regional school districts. It manages the operations of both the State Employees' Retirement System (SERS) and Teachers' Retirement System (TRS), and reports the results of operations and net assets available to fund pension benefit as Pension Trust funds. Pursuant to the pension reform law, effective in FY88, the Commonwealth is funding its pension liabilities on a long term schedule. The original schedule would have eliminated the unfunded pension liability in 40 years, by the year 2028. A new funding schedule approved in FY97 is intended to eliminate the unfunded pension liability by the year 2018. It is the responsibility of the Public Employee Retirement Administration Commission (PERAC) to complete actuarial updates for the funding schedule.

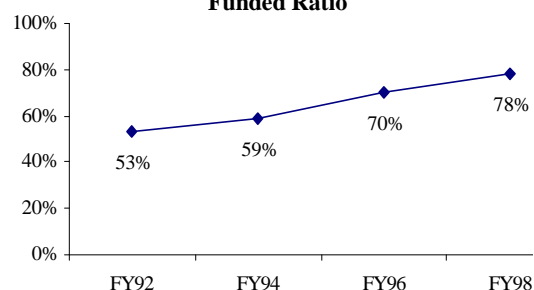
The actuarial report for SERS, TRS, and for the State-Boston Retirement System was published by PERAC as of January 1, 1998. The Commonwealth changed three assumptions increasing the liability by \$2.3 billion. The actuarial assumptions used a 8.25% investment rate of return with a 1983 Group Annuity Mortality table. The assets were valued at 97% of Market Value for the actuarial valuation of assets. The rate of salary increase was assumed at 6% and cost of living increase was assumed at 3%.

The Pension Funding Progress Graph presents the excellent results over the past six years of meeting the objective of having a fully funded plan. Footnote 10 details the progress in a schedule by system.

**Fund Balance
For Unemployment Compensation Fund**



**Pension Funding Progress
Funded Ratio**



The following table presents a five-year trend analysis of the Pension Trust Funds operations:

Pension Trust Funds (Amounts in millions)					
	<u>FY94</u>	<u>FY95</u>	<u>FY96</u>	<u>FY97</u>	<u>FY98</u>
Beginning fund balances	\$ 11,121.1	\$ 11,563.1	\$ 13,483.2	\$ 15,956.2	\$ 19,560.0
Revenues	1,376.3	2,902.1	3,560.6	4,729.4	4,905.2
Expenses	934.3	982.0	1,087.6	1,125.6	1,243.9
Excess	442.0	1,920.1	2,473.0	3,603.8	3,661.3
Ending fund balances	<u>\$ 11,563.1</u>	<u>\$ 13,483.2</u>	<u>\$ 15,956.2</u>	<u>\$ 19,560.0</u>	<u>\$ 23,221.3</u>

UNIVERSITY AND COLLEGE FUND TYPE

Since FY93 the CAFR has presented the University and College system in accordance with the AICPA Industry Audit Guide, "Audits of Colleges and Universities." This presentation combines financial activity from all fund types for:

- the University of Massachusetts, including its campuses at Amherst, Boston, Dartmouth, Lowell, Worcester Medical School, and the Teaching Hospital as well as its component units and foundation.
- the State College system of nine state colleges, which provide four-year post-secondary education, and the State College Building Authority.
- the Community College system of fifteen community colleges which provide two-year post-secondary education programs.

The University and College Fund Type reports a positive GAAP fund balance. Approximately \$2.4 billion of this fund balance is restricted or designated in plant funds, endowment funds, or other purposes.

University and College Fund Type Operations

(Amounts in millions)

	<u>FY94</u>	<u>FY95</u>	<u>FY96 (1)</u>	<u>FY97</u>	<u>FY98</u>
Beginning fund balances	\$ 2,010.4	\$ 2,034.9	\$ 2,164.9	\$ 2,363.3	\$ 2,512.2
Revenues and other additions	1,449.5	1,536.7	1,816.6	1,823.7	1,461.6
Expenditures and other deductions	2,006.4	2,082.0	2,254.4	2,381.8	2,053.9
Net transfers, including state appropriations	581.4	601.6	636.2	707.0	781.2
Net assets transferred to UMass Memorial Health Care, Inc. .	-	-	-	-	(70.5)
Loss from discontinued operations	-	-	-	-	(9.6)
Net Increase	<u>24.5</u>	<u>56.3</u>	<u>198.4</u>	<u>148.9</u>	<u>108.8</u>
Ending fund balances	<u>\$ 2,034.9</u>	<u>\$ 2,091.2</u>	<u>\$ 2,363.3</u>	<u>\$ 2,512.2</u>	<u>\$ 2,621.0</u>

(1) As restated for addition of component units

In FY98, the University of Massachusetts and 14 colleges are commended for producing stand alone audited financial reports in conformity with Generally Accepted Accounting Principles. This list includes eight of the fifteen community colleges, Berkshire Community College, Bristol Community College, Holyoke Community College, Massasoit Community College, Springfield Technical Community College, Middlesex Community College, Mount Wachusett Community College and Quinsigamond Community College. In addition, six of the nine state colleges including Bridgewater State College, the Massachusetts College of Art, Framingham State College, Fitchburg State College, Westfield State College, and Worcester State College produced audited financial statements. Each of these schools has demonstrated accountability to its trustees, the Governor and Legislature, and to all concerned parties with audited financial statements prepared in accordance with GAAP.

For several years both the Comptroller's Office and the Board of Education (previously the Higher Educational Coordinating Council) have encouraged all schools as a matter of policy to commit the requisite resources and effort to produce stand alone audited financial statements. The role of publicly subsidized higher education is important to the continued enhancement of the Commonwealth's economy and quality of life. Accordingly, the financial health of the universities and colleges is an important public policy concern. In the current legislative session, the Office of the Comptroller and the Board of Higher Education has requested the Governor to file legislation to require stand-alone audited financial statements in conformity with GAAP for all respective institutions.

COMPONENT UNITS

The Commonwealth's relationship to the independent public authorities, reported as Component Units, is based on statute and contracts between the Commonwealth and these entities.

Component Units Operations

(Amounts in millions)

	Beginning Retained Earnings	Operating Gain/ (Loss)	Subsidy	Other Changes	Ending Retained Earnings
Massachusetts Bay Transportation Authority.....	\$ (191)	\$ (581)	\$ 653	\$ (38)	\$ (157)
Massachusetts Turnpike Authority.....	357	29	-	(18)	368
Regional Transit Authorities.....	2	(78)	56	24	4
Massachusetts Water Pollution Abatement Trust.....	71	(13)	2	12	72
Massachusetts Convention Center Authority.....	3	(11)	16	(2)	6
Corporation for Business Work and Learning.....	9	(78)	11	68	10
Government Land Bank.....	28	(8)	6	5	31
Massachusetts Community Development Finance Corporation.....	2	-	1	(1)	2
Massachusetts Technology Park Corporation.....	18	6	4	-	28
Community Economic Development Assistance Corporation.....	45	3	-	3	51
Massachusetts Corporation for Educational Telecommunications.....	4	(7)	4	2	3
Massachusetts Housing Partnership.....	14	2	4	(6)	14
Commonwealth Zoological Corporation.....	1	(4)	6	-	3
Massachusetts International Trade Council.....	-	(1)	1	1	1
Total.....	<u>\$ 363</u>	<u>\$ (741)</u>	<u>\$ 764</u>	<u>\$ 50</u>	<u>\$ 436</u>

INDEPENDENT AUDIT

The firm of Deloitte & Touche LLP, together with subcontractors Daniel Dennis & Company, Margaret Carr, CPA and Susan Perna-Damon, CPA, and assisted by the Office of the State Auditor, have performed an independent audit of the Commonwealth's general purpose financial statements for the fiscal year ended June 30, 1998. The Office of the State Auditor (OSA) is a statutorily mandated to perform audits of the accounts, programs, activities and functions of all departments, offices, commissions, institutions and activities of the Commonwealth. The OSA provides its knowledge, expertise, experience and resources as a participant in the single audit of the Commonwealth which encompasses all of the Commonwealth's financial operations.

We express our thanks to the staff of the respective firms and the Office of the State Auditor for their professionalism, advice and counsel. The auditors report is presented in the Financial Section.

INTERNAL CONTROL ENVIRONMENT

Massachusetts General Law, Chapter 647 of the Acts of 1989, places authority and responsibility for internal controls with the head of each executive department, constitutional office, and branch of government. The Office of the Comptroller issues internal control guidelines and the Office of the State Auditor may investigate departments with risk of internal control weaknesses.

These two offices have continued to deliver joint training sessions for department managers regarding their responsibility for internal control in the Commonwealth's highly automated environment.

Absolute assurance with respect to internal control is prohibitively expensive. Using risk assessment criteria set forth in the guidelines and stressed in the training, the objectives of the Commonwealth's internal control structure are to provide management and the public with reasonable assurance that internal control systems do not have material weaknesses. The reader is referred to the separately published Commonwealth Single Audit Reports for additional information on internal controls.

REPORTING ENTITY

The financial statements incorporate the fiscal activities of 151 departments, agencies, boards, commissions, institutions of higher education, the judicial and legislative branches of government, and constitutional offices. These departments record their daily financial operations in the state accounting system called the Massachusetts Management Accounting and Reporting System (MMARS), operated by the Office of the Comptroller.

In addition, the financial statements include independent public authorities, and the State Employees' and Teachers' Retirement Systems. These component units meet the GAAP criteria for inclusion in the reporting entity, which are further described in Note 1 to the general purpose financial statements.

ACCOUNTING SYSTEM AND BUDGETARY CONTROL

MMARS is the computerized, statewide accounting system used by all departments to control and account for their financial activity under the statutory basis of accounting. The financial operations of the authorities and certain non-appropriated higher education funds are accounted for through their own independent accounting systems.

MMARS is designed to satisfy all requirements of the Commonwealth's statutory basis of accounting and financial reporting. Any additional information needed to prepare financial statements according to GAAP is provided through a combination of MMARS system-generated data, information compiled by departments, and the submission of audited financial statements from certain independent authorities.

Note 2 to the general purpose financial statements provides a reconciliation between the General and Budgeted Special Revenue Funds on a statutory basis and the GAAP basis presented in the general purpose financial statements.

CASH AND INVESTMENTS

Cash and investments are controlled by the State Treasurer. Each department deposits cash receipts daily into a Treasury controlled bank account. Weekly and daily warrants for disbursements are prepared by the Comptroller, and reviewed and approved by the Governor's Council; disbursements are issued by the Treasurer. The banking and disbursement process has been recently streamlined to optimize the use of electronic funds transfer and electronics benefits transfer.

A system of bank depository and disbursement accounts and lockboxes is employed by the Treasurer's Office to maximize daily cash balances. The Treasurer manages these cash balances in pooled investment funds to optimize interest earnings. The Treasurer's Office invests cash from these general accounts in short-term securities and other investments. A discussion of cash and investments is presented in Note 3 to the general purpose financial statements.

The Treasurer is also responsible for quarterly cash flow plans, weekly variance reports, and, jointly with the Executive Office for Administration and Finance, annual and quarterly cash management plans. Taxes and non-tax inflows, warrants, other outflows, and short and long-term borrowings are monitored against these plans.

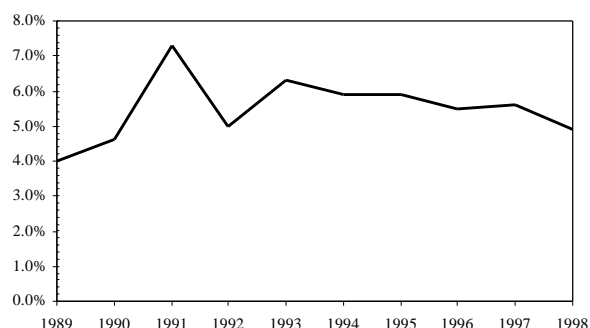
FY98 is the fifth year of the Commonwealth's implementation of the U.S. Cash Management Improvement Act (CMIA). The CMIA requires the states to measure interest income on federal funds drawn from the U.S. Treasury prior to disbursement, and for the U.S. Treasury to measure interest income on funds drawn down subsequent to disbursement. A settlement of interest due to or due from the state and federal government is computed. For FY98, the net settlement is in favor of the Commonwealth.

DEBT

Long-Term Debt (Amounts in billions)

Fiscal Year	Authorized - Unissued	Principal Outstanding
1998	\$12.3	\$11.0
1997	12.0	10.3
1996	8.2	10.1
1995	5.9	9.6
1994	4.5	9.4

Debt Service as a Percent of Governmental Expenditures



The Commonwealth funds its capital appropriations by authorizing the issuance of long-term bonds. The Long-Term Debt chart sets forth the trend of the Commonwealth's tax-supported long-term indebtedness for the last five years.

To limit the Commonwealth debt burden, and control the degree to which debt service creates pressure on the operating budget, the Administration has implemented a five-year capital spending plan. This administrative policy has existed for several years, and the effect of debt service on the operating budget is depicted on the following graph of Debt Service as a % of Governmental Expenditures.

In FY97, Standard and Poor's upgraded, the rating for Commonwealth's General Obligation Debt from "A+" to "AA-". The effect of the capital spending plan policy, the acceleration of funding of the Commonwealth's pension liability, and the string of operating surpluses were cited as reasons for the upgrade. The current credit ratings from Moody's is Aa3 and Fitch Investor Services is AA-.

As authorized by state finance law, the State Treasurer may utilize short-term borrowing to support governmental cash flow. No such borrowings occurred during the fiscal year.

Other debt consists of certificates of participation and capital lease agreements. Such financing arrangements are used to acquire capital assets, for example computer equipment and motor vehicles. The Commonwealth continued to utilize this form of financing in FY98.

Additional information on Commonwealth debt, including guaranteed debt of independent public authorities, is presented in Notes 7, 8, and 12 to the general purpose financial statements.

RISK FINANCING

The Commonwealth assumes the risk of loss for property damage and personal injury, breach of contract, condemnation proceedings, and other alleged violations of law, and is defended by the Attorney General's Office in such cases. In FY98, approximately \$44 million was expended to resolve such claims in special and existing appropriations. Based on the Attorney General's evaluation of cases in which it is probable that a judgment will be rendered against the Commonwealth, and a loss incurred, an additional \$83.9 million has been accrued in the Governmental Funds at June 30, 1998.

ECONOMIC AND FINANCIAL PROSPECTS

Massachusetts employment grew 2.2% in 1994, 0.9% in 1995 and 1.1% in 1996, and 1.0% in 1997. The Massachusetts unemployment rate, currently at 3.0%, remains below the national rate of 4.5% (August 1998). Commonwealth per capita income continues to outpace the nation as shown in the [Per Capita Income graph](#).

The Commonwealth, with an international reputation for medical, cultural, historical, and educational institutions, is the economic and educational hub of New England. The Commonwealth's economy remains diversified but its strongest component is its knowledge-based technology and service industries.

Massachusetts' infrastructure provides strong support for this knowledge-based economy. There are over 120 colleges and universities located in Massachusetts, and 33.5% of the residents over age 25 have earned bachelor's degrees, compared to 23.9% for the United States as a whole.

Our capital, Boston, has over 20 hospitals and three medical schools. Tourism is a significant component of the economy. For 1996, the latest data available, Massachusetts Office of Travel and Tourism estimates that over 28.1 million visitors spent over \$10.2 billion in the Commonwealth in 1996. The Commonwealth ranked eleventh among states in exports with \$18.0 billion in 1997.

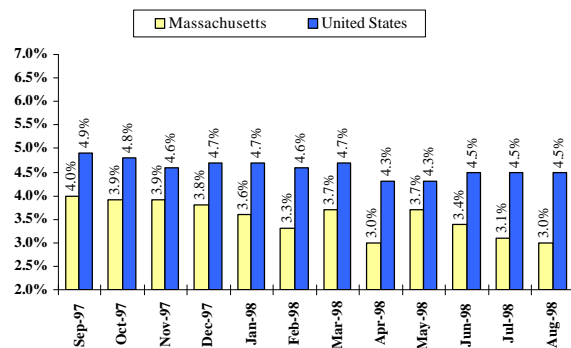
A continued low rate of inflation is expected to keep wage growth low and allow for slow-paced positive growth in the Massachusetts economy.

The Commonwealth's FY99 budget forecast is consistent with the economic trends presented above. Budgeted revenues and other sources, as estimated by the Executive Office for Administration and Finance, are currently projected at approximately \$19,904.3 million. The estimate assumes tax revenues will be 3% lower than the FY98 actual collections. Therefore FY99 tax revenues are estimated at \$13,610.1 million.

The Commonwealth's total budgeted expenditures and other uses in FY99 are projected at \$20,579.9 million. This estimate assumes the spending in the Commonwealth's seven major programs (Local Aid, Medicaid, Employee Health Insurance, Public Assistance, Debt Service, Pensions and Subsidies to Transit Authorities), which comprise over 60% of budgetary spending, will increase by 4.7% over FY98.

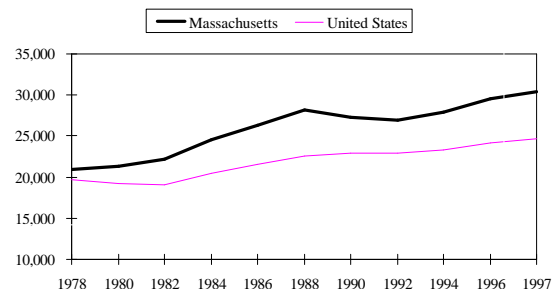
The FY99 opening fund balance, for budgeted funds, on a statutory basis is \$2,192.1 million. If the FY99 forecast is realized, the ending fund balance will be approximately \$1,516.5 million. It is noteworthy that, of the \$1,516.5 million, approximately \$1,191.6 million is projected to be reserved in the Commonwealth's Stabilization Fund. In this forecast, the Commonwealth has continued a conservative revenue estimating approach. As in past years, ending fund balances may be higher due to this conservative approach to forecasting.

**Monthly Unemployment Rate
September 1997 - August 1998**



Source: Massachusetts Department of Employment and Training

**Per Capita Income 1978 - 1997
(in 1997 dollars)**



Source: United States Department of Commerce, Bureau of Economic Analysis

The Administration is engaged in an extensive mid-year review of this estimate. The Governor will release his recommended budget for FY2000 in late January, at which time the FY99 forecast may be revised.

SIGNIFICANT ACCOMPLISHMENTS

In FY98, there were a number of significant public policy accomplishments that demonstrate accountability and financial management.

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Commonwealth for its Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports. This is the eighth consecutive year that the Commonwealth has received this award.

On a statutory basis, the Commonwealth has accomplished a positive fund balance for the eighth consecutive year. Balance in the budgeted funds of \$2.2 billion is more than 15% of annual tax revenues for fiscal year 1998. Also, per special statutory direction approximately \$300 million was transferred to capital outlay, instead of remaining in the budgetary surplus. Of the \$2.2 billion, \$1.2 billion is in the Stabilization Fund. This fund, sometimes called the "rainy day" fund, represents the Commonwealth's reserves for future purposes.

The fiscal year 1998 budget contained three tax cuts with an aggregate fiscal 1998 cost estimated by the Department of Revenue to have been \$60.9 million - an increase in the child dependent deduction from \$600 to \$1,200 for children up to age 12 (\$15.3 million), a tax credit of up to \$6,000 over four years for septic tank improvements (\$17 million) and an earned income tax credit amounting to 10% of the federal credit (\$28.6 million). The fiscal 1999 impact of these tax cuts is expected to be \$15.3 million, \$18 million and \$30 million, respectively.

On November 6, 1997, Governor Cellucci approved legislation exempting military pensions from the state income tax, effective January 1, 1998. The Department of Revenue estimates that this exemption resulted in a fiscal 1998 revenue reduction of \$25 million and an approximately \$18 million reduction on an annualized basis thereafter.

On July 21, 1998 Governor Cellucci approved legislation reducing the rate of tax on "Part A" income (interest and dividends) from 12% to 5.95%, effective January 1, 1999. The FY99 cost is estimated to be \$117 million, the fully annualized cost is estimated to be \$239 million. The legislation also phased in a doubling of the personal exemptions applicable to the "Part B" ("earned") income tax, effective January 1, 1998, with an estimated FY99 cost of \$600 million (which includes costs for January 1, 1998 to June 30, 1998) and an estimated fully annualized cost of \$492 million.

In addition, the legislation conformed state tax law to federal law with respect to Roth and educational IRA's, deferred compensation, capital gains on the sale of a personal residence, travel and entertainment deductions and the definition of short-term capital gains. The estimated aggregate FY99 cost of these additional changes is less than \$5 million, and the estimated aggregate annualized cost, excluding the Roth IRA, is also less than \$5 million. The full impact of the Roth IRA change will only be felt as those now contributing to Roth IRA's withdraw their investments, over a period starting more than 20 years from now.

The non-tax revenue optimization campaign was very successful in FY98. With special authorization in the budget, a task force was comprised of key persons from the Executive Office for Administration and Finance, the Budget Bureau, the Information Technology Division, and the Comptroller's Office. The taskforce provided leadership and sponsored projects by which outside experts were engaged on a contingent fee basis, and departments optimized various sources of non-tax revenue (such as federal reimbursement) by over \$33.4 million during fiscal year 1998. The fiscal year 1997 non-tax revenue optimization amount was \$39.1 million. The initiative is dedicated to optimizing all collection potential within the framework of existing fee structure and program authorizations. The non-tax revenue optimization campaign continues in FY99.

A large number of projects to enhance or re-engineer business processes with new technology have been performed. Such projects relate to an array of Commonwealth activities, including automation of welfare eligibility determination, management of cases in the legal system, creating a new statewide client server infrastructure, and significant changes to the Commonwealth's administrative and fiscal systems.

Examples of projects from the domain of administrative or fiscal systems include: re-engineering the Commonwealth disbursement practices to the model of electronic commerce, including electronic data interchange, electronic funds transfer, and electronic benefits transfer; exploiting the internet with web-enabling procurement and other applications; replacing the existing array of payroll and human resource systems with a state-of-the-art Human Resource Compensation Management System.

The Commonwealth is continuing its effort to remediate the "Year 2000 problem" in its mechanical and data processing systems. The Year 2000 problem is the result of shortcomings in many electronic data processing systems and other equipment that make operations beyond the year 1999 troublesome. For many years, computer programmers eliminated the first two digits from the year when writing programs. Accordingly, many programs, if not corrected, will not be able to distinguish between the year 2000 and the year 1900. These problems have the potential for causing a disruption of governmental services.

In June 1997, the Executive Office for Administration and Finance established a Year 2000 Program Management Office within the Information Technology Division. The purpose of this office is to ensure accurate monitoring of the Commonwealth's progress in achieving "Year 2000 compliance". The program office has asked agencies to identify "mission critical" and "essential" systems.

Mission critical systems are those which directly affect the health, safety or livelihood of citizens, which directly affect state revenues or whose loss would severely jeopardize agency delivery of services. Essential systems' loss would cause disruption of some agency services but would not prevent the agency from delivering primary services. The program office has identified 261 mission critical and 192 essential systems. The Commonwealth currently expects that all mission critical systems will be year 2000 compliant by December 31, 1999. The statewide accounting and payroll systems attained Year 2000 compliant status as of December 7, 1999.

In addition, the Office of the State Auditor has conducted extensive examinations of the Commonwealth systems for "Year 2000" compliance.

Those seeking more detailed information on the Commonwealth year 2000 efforts should visit the Information Technology Division year 2000 web page: www.state.ma.us/Y2K or the Office of the State Auditor's web page: www.state.ma.us/SAO.

Under the leadership of the Information Technology Division, several departments across the branches of government continue to collaborate in joint ventures to leverage resources in these projects.

This approach is yielding significant results both in terms of shared functionality and interoperable systems, and increased purchasing power through joint procurements. Exciting partnerships with internal Commonwealth departments and private sector business partners have developed. Several of these projects have received national recognition and awards.

With this technique and through its array of projects, the Commonwealth is again the focus of attention by other states, the U.S. Government, and the private sector. The prospects for future success are outstanding.

RECOMMENDATIONS AND CONCLUSIONS

The Office of the Comptroller has a unique perspective on state finance based on insights gained through control of day-to-day operations and experience with GAAP. With this background, we take this opportunity to make proposals intended to strengthen state finance.

Consistent with the prior recommendations, the Office of the Comptroller believes the Commonwealth's current fund structure should be streamlined. The Local Aid Fund has increased outflows associated with the Education Reform Act of 1994, and exhibits a structural budgetary imbalance. The continued existence of this Fund should be examined. In addition, the proliferation of budgeted Special Revenue Funds has fractured, not strengthened, the budget process.

As special interest groups have enjoyed political success in carving out dedicated revenues and removing operations from the general budget, the capacity for centralized planning and control has diminished. The numerous non-budgeted Special Revenue Funds and Capital Projects Funds further complicate efforts to obtain a comprehensive view of state finance.

The Office of the Comptroller has proposed Legislation to simplify the fund structure, reduce the number of funds to a more manageable number, and eliminate fund deficits.

In addition, the Office of the Comptroller has proposed legislation to simplify the definition of a balanced budget, and the terms and conditions for deposits into the Stabilization Fund . This legislation would result in a more coherent and understandable picture of the Commonwealth's Governmental Funds financial activity.

The Commonwealth has a tremendous opportunity to employ new technologies to improve its programmatic, financial, and administrative operations. In FY93 the Governor proposed and the Legislature enacted the first Information Technology Capital Outlay. In FY97, the Governor and Legislature enacted a second Information Technology Capital Outlay. With this funding the opportunity exists to re-engineer old business practices and engage new technology. An unprecedented interdepartmental coalition under the leadership of the Commonwealth's Chief Information Officer creates an exciting opportunity to make strategic investments that will position the Commonwealth successfully into the next century.

The Commonwealth has authorized and committed itself to a number of capital projects over the next several years. This includes the Central Artery/Tunnel Project and several other initiatives that will generate significant pressure on the self-imposed cap on capital spending. In FY98, several mechanisms were established to address this situation, including utilization of approximately \$319.3 million from budgetary surplus for capital projects. Continued efforts and diligence to manage capital spending is merited.

The Commonwealth should enact a program to fund the liability for the State Employees Workers' Compensation Program as new costs are incurred and amortize the accumulated unfunded liability of \$242.7 million. This amount did not materialize in a single year and a multi-year funding schedule is recommended. Options to furnish the necessary funding include a "surcharge" to the current statutory chargeback to state agencies, special lump sum appropriations, a redirection of investment earnings, and other actions. Accumulating assets to satisfy the current unfunded liability will be another demonstration of interperiod equity and sound financial management. In contrast, for the special workers' compensation program for the Central Artery/Tunnel Project, the Commonwealth should consider decreasing annual contributions. In this instance, it appears the amount accumulated for current and future claims is more than adequate. Since both federal and state government contribute to the program, any change to annual contributions must be structured accordingly.

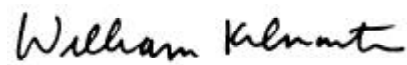
Consistent with this recommendation, the Commonwealth should move certain internal service activities from the budgeted funds to a new Internal Service Fund. The fiscal operation of activities such as worker's compensation and group health insurance would be improved by a GAAP approach.

Regarding the institutions of higher education, the time has come for each school to produce audited stand-alone financial statements in conformity with generally accepted accounting principles. While many schools have moved into this practice of their own volition, and others are currently in the preparation process, it is appropriate to make this a statutory requirement. The Comptroller's Office and Board of Higher Education will seek legislation to accelerate such an effort.

Now that the Commonwealth has accomplished excellent financial condition, the ongoing challenge is to sustain this status. Maintaining the structural balance between inflows and outflows will be difficult. There is a multitude of projects and proposals, each with merit, to spend the accumulated surplus. To assure continued fiscal health, the Governor and Legislature must resist the pressure of short term actions and insist on continued discipline for long term interperiod equity as evident by GAAP.

This is the last Financial Report produced under my tenure as State Comptroller. I am grateful for the support of my wife, Kathy and children, Jerry and Meridith, to my career in public service. During the past 20 years it has been my privilege to work in several other departments and observe and participate in remarkable changes and progress in state government. The commitment to excellence is demonstrated in the positive financial condition and array of advanced computer systems. The cadre of current and former state employees, ranging from elected officials such as Governor Cellucci to front-line direct service workers have earned my enduring respect. I specifically emphasize my admiration and appreciation for the dedicated professional staff at the Office of the Comptroller. Your commitment and service has energized and inspired me each day. I dedicate this Report in your honor. In closing, I suggest the citizens should take great satisfaction and pride in their Commonwealth.

Respectfully transmitted,

A handwritten signature in black ink that reads "William Kilmartin". The signature is written in a cursive, flowing style.

William Kilmartin
Comptroller

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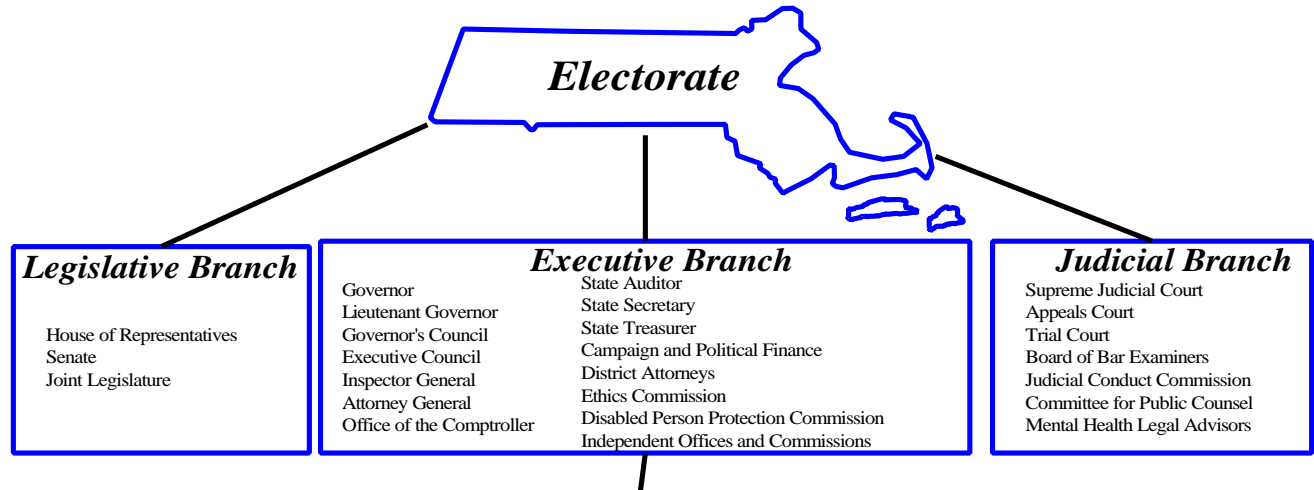
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State Agencies

Administration and Finance

Executive Office Secretary of Administration and Finance
 Developmental Disabilities
 Appellate Tax Board
 Fiscal Affairs Division
 Operational Services Division
 Civil Service Commission
 Department of Revenue
 Department of Veteran Services
 Division of Administrative Law Appeals
 Division of Asset Management
 Group Insurance Commission
 Commission Against Discrimination
 Teachers' Retirement Board
 Public Employee Retirement Administration Commission
 Human Resource Division
 Information Technology Division
 Massachusetts Office on Disability
 Bureau of State Buildings
 George Fingold Library

Public Safety

Executive Office of Public Safety
 Architectural Access Board
 Committee on Criminal Justice
 Criminal History Systems Board
 Criminal Justice Training Council
 Department of Correction
 Department of Public Safety
 Department of Police
 Governor's Highway Safety Bureau
 Massachusetts Emergency Management Agency
 Merit Rating Board
 Military Division
 Chief Medical Examiner
 Parole Board
 Registry of Motor Vehicles
 Board of Building Regulations
 Department of Fire Services
 Sheriff's Department - Franklin
 Sheriff's Department - Middlesex

Economic Development

Department of Economic Development
 Division of Housing & Community Development

Education

Department of Education
 Higher Education
 University System
 State and Community Colleges

Elder Affairs

Executive Office of Elder Affairs

Environmental Affairs

Executive Office of Environmental Affairs
 Department of Food and Agriculture
 Department of Environmental Management
 Department of Environmental Protection
 Fisheries and Wildlife Environmental Law Enforcement
 Metropolitan District Commission
 State Reclamation Board
 Low Level Radioactive Waste

Transportation and Construction

Executive Office of Transportation and Construction
 Massachusetts Aeronautics Commission
 Massachusetts Highway Department

Health and Human Services

Executive Office of Health and Human Services
 Department of Mental Health
 Department of Mental Retardation
 Department of Public Health
 Department of Social Services
 Department of Transitional Assistance
 Department of Youth Services
 Division of Medical Assistance
 Massachusetts Commission for the Blind
 Massachusetts Commission for the Deaf and Hard of Hearing
 Massachusetts Rehabilitation Commission
 Office for Child Care Services
 Office for Refugees and Immigrants
 Soldier's Home Chelsea, Holyoke
 Division of Health Care Finance & Policy

Labor

Department of Labor & Work Force Development
 Conciliation and Arbitration
 Division of Industrial Accidents
 Joint Labor Management Commission
 Labor Relations Commission
 Division of Employment and Training

Consumer Affairs

Office of Consumer Affairs & Business Regulations
 Board of Medicine
 Department of Telecommunications and Energy
 Division of Banks
 Division of Insurance
 Division of Registration
 Division of Standards
 State Racing Commission
 Alcoholic Beverages Control Commission
 Energy Facilities Siting Board
 Division of Energy Resources

CONSTITUTIONAL OFFICERS

Argeo Paul Cellucci
Governor

Jane Swift
*Lieutenant Governor – Elect**

William F. Galvin
Secretary of State

L. Scott Harshbarger
Attorney General

Thomas Reilly
*Attorney General – Elect***

Joseph D. Malone
Treasurer and Receiver-General

Shannon O'Brien
*Treasurer and Receiver-General – Elect***

A. Joseph DeNucci
Auditor

LEGISLATIVE OFFICERS

Thomas F. Birmingham
President of the Senate

Thomas M. Finneran
Speaker of the House

JUDICIAL OFFICERS

Herbert P. Wilkins
Chief Justice, Supreme Judicial Court

Joseph P. Warner
Chief Justice, Appeals Court

Barbara A. Dortch-Okara
Chief Justice for Administration and Management, Trial Court

**Lieutenant Governor Elect takes office January 7, 1999*

***The Attorney General Elect and the Treasurer Elect take office January 20, 1999*



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For its Comprehensive Annual
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for the Fiscal Year Ended
June 30, 1997

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Douglas R. Ellsworth
President

Jeffrey L. Esser
Executive Director



The Swan Boats at the Public Gardens in Boston. Since 1877, these elegant two-ton pedal-powered boats have been a fixture on the lagoon in the summer months. For \$1.75 for an adult or ninety-five cents for a child, it is a very popular treat with the locals and tourists alike.